

ESMA as the EU supervisor for credit ratings agencies (CRAs)



Agenda

1. Introduction to ESMA
2. Focus on ESMA as the EU exclusive supervisor for credit rating agencies (CRAs)
3. On-going supervision of CRAs by ESMA
4. The forthcoming CRA3 Regulation



1. Introduction to ESMA

5 October 2012 - Venezia

ESMA is operational since 1 January 2011 (Regulation 1095/2010/EC)

•Mission

- enhance investor protection
- reinforce stable and well-functioning financial markets in the European Union

•Objectives

- building the single rule book for EU financial markets and ensuring its consistent application and supervision across the EU
- contributing to the supervision of financial service firms with a pan-European reach, either through **direct supervision** or through the active coordination of national supervisory activity



2. ESMA, the exclusive supervisor for CRAs

5 October 2012 - Venezia

The current regulatory framework for CRA supervision consists of the regulation (EC) No 1060/2009 (the so-called CRA1) as amended by the regulation (EU) 513/2011 (CRA2).

CRA1 (adopted in September 2009) originally gave supervisory competence over CRAs to National Competent Authorities

Following the adoption of CRA2 (May 2011), ESMA has become since 1 July 2011 the exclusive supervisor for credit rating agencies.

This is the first area where a European Supervisory Authority has received the task to directly supervise financial institutions (in 2013 ESMA will also start supervising the so-called Trade Repositories).



2. ESMA the exclusive supervisor for CRAs

5 October 2012 - Venezia

ESMA Supervisory competences

- The CRA Regulation applies to credit rating issued by credit rating agencies registered in the EU.
- ESMA is required to ensure that the CRA Regulation is applied.

In order to perform such duties, ESMA has the power to:

- i) request information
- ii) conduct on-site inspections
- iii) take supervisory measures
- iv) impose fines



2. ESMA the exclusive supervisor for CRAs

5 October 2012 - Venezia

Scope and limits of ESMA Supervisory competences

- The supervision of CRAs by ESMA includes:
 - (i) the use of methodologies, that have to be rigorous, systematic, continuous, and subject to validation;
 - (ii) the disclosure of methodologies and the presentation of ratings to the public;
 - (iii) the presence of sound internal policies and procedures to prevent, identify, eliminate or manage and disclose any conflicts of interest;
 - (iv) arrangements for sound corporate governance.

- On the other hand, neither ESMA nor any other public authority may interfere with the content of credit ratings or methodologies.



2. ESMA the exclusive supervisor for CRAs

5 October 2012 - Venezia

Main responsibilities of the CRA Unit

- Supervision on registered CRAs – main activities include:
 - **Registration** of new CRAs / **identification of entities that are supposed to submit to ESMA a request for registration**
 - **Ongoing supervision** of CRAs
 - **CEREP** (CEntral REPository on CRA ratings and performance)
 - **SOCRAT** (Supervision Of CRA Tool)
 - **Enforcement**
 - **Risk analysis** (market intelligence / risk categorisation)
- Policy development - main workstreams include:
 - **Regulation** (RTS, CRA III Proposal, etc)
 - **Supervision Guidance**
 - **Endorsement/cooperation agreements with non-EU authorities**



2. ESMA the exclusive supervisor for CRAs

5 October 2012 - Venezia

Role of National Competent Authorities (NCAs) - I

- **Participation in ESMA governance**

The Chairs of the NCAs are members of ESMA Board of Supervisors (and six of them also of ESMA Management Board) on a personal capacity. Representatives from NCAs are part of the ESMA Technical Committee for CRAs.

- **Delegation of tasks**

ESMA can delegate specific supervisory tasks to the competent authority of a Member State, for instance where a supervisory task requires knowledge and experience with respect to local conditions, which are more easily available at national level.

The tasks that can be delegated include the carrying out of specific investigatory tasks and on-site inspections.

ESMA is required to compensate the delegated competent authority in accordance with what provided by the Commission Regulation on fees.

So far, no specific tasks have been delegated by ESMA to NCAs.



2. ESMA the exclusive supervisor for CRAs

5 October 2012 - Venezia

Role of National Competent Authorities (NCAs) - II

- **Contribution to supervisory colleges for CRA registration**

CRA1 had entrusted colleges of NCAs for the registration of the existing CRAs (Consob was part of the college responsible for the registration of DBRS, Fitch, Moody's, S&P's and had exclusive responsibility for the registration of CRIF). ESMA has now exclusive competence for the registration of new CRAs.

- **Exchange of information**

The exchange of information between ESMA and the national competent authorities is of great importance for a proper assessment of the risks in the CRA industry. For instance, national competent authorities play an important role in identifying illegally operating CRAs in the EU and informing ESMA accordingly.



2. ESMA the exclusive supervisor for CRAs

5 October 2012 - Venezia

CRAs registered and under the supervision of ESMA

- ✓ 18 registered CRAs, including S&P, Moody's and Fitch (the *Big 3*)
- ✓ The *Big 3* have registered 16 legal entities
- ✓ Total: 31 legal entities registered
- ✓ 1 certified Japanese CRA



2. ESMA the exclusive supervisor for CRAs

5 October 2012 - Venezia

CRAs registered and under the supervision of ESMA

| CRA | Country of residence | Status | Effective date |
|------------------------|-------------------------------------|------------|----------------|
| ASSEKURATA | DE | Registered | 16/11/10 |
| A.M. Best Europe | UK | Registered | 8/9/11 |
| Axesor SA | ES | Registered | 1/10/12 |
| BCRA | BG | Registered | 6/4/11 |
| Capital Intelligence | CY | Registered | 8/5/12 |
| CPR | PT | Registered | 26/8/11 |
| Creditreform Rating | DE | Registered | 18/5/11 |
| CRIF | IT | Registered | 22/12/11 |
| DBRS | UK | Registered | 31/10/11 |
| Euler Hermes Rating | DE | Registered | 16/11/10 |
| European Rating Agency | SK | Registered | 30/7/12 |
| Feri | DE | Registered | 14/4/11 |
| Fitch | DE, ES, FR, IT, PL, UK (2 entities) | Registered | 31/10/11 |
| GBB | DE | Registered | 28/7/11 |
| ICAP | DE | Registered | 7/7/11 |
| JCRA | JP | Certified | 6/1/11 |
| Moody's | CY, DE, ES, FR, IT, UK | Registered | 31/10/11 |
| Scope Credit Rating | DE | Registered | 24/5/11 |
| S & P's | FR, IT, UK | Registered | 31/10/11 |



3. On-going CRA supervision by ESMA

5 October 2012 - Venezia

- ESMA applies a risk-based supervisory approach on the basis of an annual work programme where the main risks are identified.
- We are developing individual risk scorecards for all the CRAs we supervise and we use a range of regulatory tools and powers to address and mitigate the risks we identify.
- We are proceeding according to a hierarchy of risks generated by the credit rating industry: risks that encompass the sector as a whole, risks attached to specific categories of ratings, and risks generated by specific CRAs.
- This feeds into the annual work programme which is approved by ESMA's Board of Supervisors and which consists of various reviews (thematic and individual) focusing on the main risks identified.



3. On-going CRA supervision by ESMA

5 October 2012 - Venezia

- Following the registration of the main CRAs at the end of October 2011, in December 2011 ESMA conducted a first round of on-site inspections
- The inspections took place at Fitch, Moody's, and S&P's
- Given that one of the main objectives of the CRA Regulation is to protect the stability of financial markets and investors, ESMA deemed appropriate to address the most relevant players in the credit rating agencies sector.
- ESMA published a report with the main findings of these initial examinations on 22 March 2012.



3. On-going CRA supervision by ESMA

5 October 2012 - Venezia

ESMA Report on the Supervision of CRAs of 22 March 2012

- The report refers to common issues affecting the activities of the three CRAs examined and having also general relevance for all the registered CRAs:
 - transparency of rating methodologies, disclosure and presentation of ratings;
 - adequacy of controls over IT systems;
 - recording of core internal processes and decisions; and
 - adequacy of resources devoted to internal control functions and analytical business lines.
- Individual observations have been communicated to each of the three CRAs and are not part of the report.
- The general and individual observations have been included into ESMA internal risk assessment which provides the basis for the supervisory work plans for each of the three Big3 CRAs.



3. On-going CRA supervision by ESMA

5 October 2012 - Venezia

- ESMA has just conducted a second round of inspections at the Big3 on bank rating methodologies: we are currently examining the evidence we have gathered in preparation of our supervisory findings.
- In addition, we have also performed an individual examination of the internal control functions (ie Compliance, Internal Review Function, Internal Audit, INED) of another CRA.
- In all such cases the individual CRAs involved have received or will receive confidential feedback and, where appropriate, will be asked to put mitigation actions in place.
- ESMA is also required to start enforcement procedures in case of violation of the Regulation. due to confidentiality requirements, such procedures can be disclosed only once ESMA's BoS adopts an enforcement decision.
- As requested by the CRA Regulation, ESMA will also perform at least one verification of all of the registered CRAs by June 2014.
- Finally, we are also looking at firms which might be operating within the sector without having gone through the registration process. If this proves to be the case, they will be told to comply with the Regulation or stop doing business.



4. The forthcoming CRA3 Regulation

27 June 2012 - Paris

- CRA3 proposal adopted by the EC on 15 November 2011
- General Approach adopted by the Council on 25 May 2012
- Report by Mr Domenici adopted by the European Parliament, ECON Committee, on 19 June 2012
- The final trilateral negotiation (Trilogue) is in process
- Once the final political agreement will have been reached, it will have to be ratified by the Council and by the European Parliament
- Finally, the CRA3 text will be published on the OJ of the EU

4. The forthcoming CRA3 Regulation

27 June 2012 - Paris

The CRA3 proposal provides for several new draft RTS to be adopted by ESMA

✓ The ESMA Regulation (Art. 10) provides that the RTS shall be:

- technical;
- shall not imply strategic decisions or policy choices;
- their content shall be delimited by the legislative acts on which they are based.

In preparing the draft RTS, ESMA shall:

- conduct open public consultations;
- analyse the potential costs and benefits...
...unless such steps are disproportionate in relation to the scope and impact of the draft RTS or in relation to the particular urgency of the matter;
- Opinion of the Securities and Markets Stakeholder Group.

✓ Moreover, ESMA shall consult with its Technical Committee

4. The forthcoming CRA3 Regulation

27 June 2012 - Paris

Final adoption of the new RTS

- ✓ The draft RTS would then have to be endorsed by the European Commission within three months.
- ✓ In turn, the EP and the Council shall be given a period of three months (renewable for three further months) to object to the final RTS adopted by the Commission (this period is limited to 1+1 month in case the Commission does not diverge in substance from the draft RTS submitted by ESMA).
- ✓ Finally, the RTS will be published on the Official Journal of the EU and shall enter into force on the date stated therein.

4. The forthcoming CRA3 Regulation

27 June 2012 - Paris

Tracking CRAs' shareholder base (i)

- The CRA3 proposal provides in several instance for ESMA to track CRAs' shareholder base:
 - acquisition of a minimum number of shares by the same shareholder in two or more CRAs (new Art. 6a);
 - Relevant position in a registered CRA by a relevant shareholder in another registered CRA (new Art. 6a);
 - main CRAs' shareholders have interests in the rated entity (amendments to Annex I.B.3);
 - rated entities are CRAs' major shareholders themselves (amendments to Annex I.B.3).



4. The forthcoming CRA3 Regulation

27 June 2012 - Paris

Tracking CRAs' shareholder base (ii)

•Presently, under the CRA Regulation in force and the RTS 449/2012, a CRA is required to inform on its owners' activities and the ownership of its parent undertakings:

-Art. 8.1 of the draft RTS provides that a CRA shall provide ESMA with a list of each person who directly or indirectly holds 5% or more of credit rating agency's capital or of voting rights or whose holding makes it possible to exercise a significant influence over the management of the CRA;

-Art. 14.3 of the CRA Regulation currently in force requires CRAs to notify ESMA of any material changes to the conditions for initial registration, including changes to the CRAs' ownership structure;

-this also covers the CRAs which belong to multi-national groups and CRAs that are controlled through a chain of intermediaries.

4. The forthcoming CRA3 Regulation

27 June 2012 - Paris

Tracking CRAs' shareholder base (iii)

- What the present regulatory framework does not allow ESMA to do, is to independently verify that behind a legal shareholder there is no beneficial owner of the shares.
- In this respect, the General Approach adopted by the Council provides:
 - a definition of shareholder which also includes beneficial owners (taken from Reg. 2005/60/EC on money laundering);
 - extension of provisions in Annex I.B.3 to indirect shareholders (according to Art. 10 of Directive 2004/109/EC).



4. The forthcoming CRA3 Regulation

27 June 2012 - Paris

The possible new disclosure platform for credit ratings (i)

- The general objectives would stay the same as in CEREP:
 - enhancing transparency
 - protecting investors (by facilitating the comparison of CRAs performances)
 - helping regulators to assess CRAs developments

4. The forthcoming CRA3 Regulation

27 June 2012 - Paris

•The possible new disclosure platform for credit ratings (ii)

- The new platform would provide real-time information to the public
 - ✓Under CEREPEP, CRAs provide historical and periodic ratings and ESMA calculates (performance) statistics
 - ✓Under the possible new platform, CRAs would provide real-time rating information including:
 - rating and outlook of the rated instrument;
 - information on the type of rating;
 - type of rating action;
 - date and hour of publication.



4. The forthcoming CRA3 Regulation

27 June 2012 - Paris

Possible new competences for ESMA

Among other things, the CRA3 proposal provides two new competences for ESMA:

- in its annual report, ESMA shall assess market concentration levels and related risks;
- the new proposed Annex I.B.3a introduces the duty for ESMA to verify that fees charged by CRAs are not discriminatory, based on actual costs, and not contingency-based.

ESMA would have to adopt entirely new skills and methodologies to assess risks from market concentration levels.



5 October 2012 - Venezia

Thank you for your attention

Contacts:

Paolo Santella

Senior policy officer for CRA

Phone: + 33 1 58 36 59 40

Email : paolo.santella@esma.europa.eu